Internal Revenue Service
memorandum

CC:TL-N-4568-91
MLOsborne

date: MAY 9 1991

to: Regional Counsel, Southeast Region CC:SE
Attn: Robert J. Shilliday

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request of March 6, 1991, for tax litigation advice in the above-captioned case.

ISSUE

Under I.R.C. §§ 441-444 involving a change in accounting period approved by the Commissioner, when calculating the net operating loss (NOL) for the full 12-month tax year to be compared with a short tax year, can a change in law affecting only the (hypothetical) full 12-month year be applied to the full 12-month year, with prior law applying to the actual short tax year.

CONCLUSION

The calculation of a NOL for the full 12-month year is to be treated as if the hypothetical were an actual 12-month year. Thus, a change in law affecting the hypothetical 12-month year is to be applied when comparing the hypothetical year to the actual short year, even when the change of law does not affect the short tax year.

FACTS

The taxpayer requested, and received, permission to change its annual accounting period from a fiscal year ending March 31 to a calendar year ending December 31. This necessitated a short period tax return for the period [redacted] through [redacted]. The taxpayer reported a NOL of $[redacted] for this period which was, upon examination, adjusted to $[redacted]. This adjustment is not at issue. The issue is whether this $[redacted] NOL for [redacted] may be carried over the subsequent year and deducted in full or whether it must be spread over 6 years (resulting in a yearly deduction of $[redacted]). The NOL incurred in the short year ended [redacted] was carried over and absorbed in the final return filed [redacted].

[redacted] ([redacted]) filed form 1128 and received permission to change its annual accounting period to a calendar year effective [redacted], from a March 31 fiscal year. A copy of the authorization for the taxpayer to change it's accounting period was attached to the [redacted] return. The change in accounting period was made because [redacted] planned to make a public offering in the form of a limited partnership, of which [redacted] was to be the general partner, and was advised by its investment bankers that the corporation needed to be on a calendar year for purposes of the offering. Permission was granted by the Commissioner provided that if the short period required to effect the change of annual accounting period is a tax year in which the taxpayers have a NOL, the NOL is to be deducted ratably over a 6 year period beginning with the first year after the short period unless the taxpayer can meet the one of the following exceptions:

> if the NOL resulting from the short period is $ 10,00 of less, the NOL can be carried back or over in accordance with section 172(b); or
>
> if the NOL resulting from a short period of 9 months or longer is greater then $ 10,000 <u>and is less than</u> the NOL for a full 12-month period beginning with the first day of the short period, the NOL can be carried back or over in accordance with section 172(b) (emphasis added).[1]

Because [redacted] had a NOL for the short period, and [redacted]'s short period was 9 months, it was necessary for it to compare the short period NOL to the NOL for the 12-month period ended [redacted]. Based on the taxpayers calculation they met the exception and they should be able to use all the [redacted] loss on the [redacted] return.

[redacted] had used the installment method of accounting up through the [redacted] return. In calculating the NOL for the full 12-month period, the examiner applied section 453C, which was in effect for tax years ending <u>after</u> [redacted]. This resulted in the 12-month NOL being less than the 9-month NOL

[1] The language in the approval letter is identical to language found in Rev. Proc. 85-16, 1985-1 C.B. 517, Section 3 and in Rev. Proc. 84-34, 1984-1 C.B. 508, Section 4.02(4)(a) and (b). Technically, Rev. Proc. 84-34 only applies for changes in accounting periods where no permission from the Commissioner is required. Where permission was required and received by the taxpayer, and the short period resulted in a NOL (as in the case at hand), the conditions and terms of the approval letter, reflecting Rev. Proc. 85-16, apply to the taxpayer.

(the NOL for the 12-month period as calculated by the examiner was approximately $ [redacted]), requiring a spread of the [redacted]-month NOL over 6 years. It is not disputed that if section 453C applies for the full 12-month period, the NOL for such period would be less than the short period NOL (without the application of section 453C), which would require the 6-year spread.

LAW

Sections 441 through 444 are concerned with accounting periods, generally defined as the time period in which a taxpayer regularly computes its income and keeps its books. Section 442 and section 443 require the approval of the Secretary (or his delegate the Commissioner) for a change in the taxpayer's annual accounting period.

Treas. Reg. § 1.442-1(a) provides that a taxpayer wishing to change its accounting period must obtain the prior approval from the Commissioner or the change must be authorized by the regulations. Treas. Reg. § 1.442-1(b) applies to those period changes authorized by the Commissioner, as opposed to those authorized by the regulations. This regulation provides that a period change will be approved where the taxpayer establishes a substantial business purpose, but only where the taxpayer agrees to the terms, conditions and adjustments under which the change will be effected.

Section 453C pertains to proportionate disallowance of installment sales reporting. In effect, the amount of a taxpayer's "allocable installment indebtedness" for each year is determined and then that amount is deemed a payment received (and income recognized) immediately before the close of the tax year. This section was enacted in the Tax Reform Act of 1986. The proportionate disallowance rule is effective for taxable years ending after December 31, 1986, with respect to sales of property after February 28, 1986.

ANALYSIS

[redacted] was granted permission to change its accounting period from a fiscal year end March 31 to a calendar year end December 31. The short tax year created by this period change began on [redacted], and ended on [redacted].

Section 442 requires that a taxpayer receive permission from the Secretary to change its accounting period. Treas. Reg. § 1.442-1(b)(1) provides, in part, that prior approval of a period change "will not be granted unless the taxpayer and Commissioner agree to the terms, conditions, and adjustments under which the change will be effected." The taxpayer agreed to terms and conditions, generally reflected in Rev. Proc. 85-

16. The approval letter provides a condition to the effect that if the short period is a tax year in which the corporation has a net loss, then the net loss is to be deducted ratably over a 6 year period unless two exceptions apply. If the NOL is less than $ 10,000, it may all be taken in any one year. If the NOL is over $ 10,000, however, the deduction can be taken in one year only if the NOL for the full year is greater than the NOL for a short period of 9 months or longer.[2] [redacted] had a short year of 9 months and a NOL of greater than $ 10,000; thus, it has to deduct its NOL over a 6 year period unless its NOL for a full 12-month period is greater than its short period NOL.

Treas. Reg. § 1.442-1(b)(1) provides, in part, that the agreement between the taxpayer and the Commissioner under which a period change will be effected shall apply terms and conditions "to prevent a substantial distortion of income which otherwise would result from the change." The creation of a short period in which there is a substantial net operating loss is among the examples provided in the regulation of a change which would substantially distort income. [redacted]'s NOL for the short period ended [redacted], created a substantial NOL of approximately [redacted] dollars (after adjustment). This is a situation contemplated in the regulation; an example of a substantial distortion of income caused by the period change to which terms and conditions are to be attached. The terms are spelled out in the approval letter: deduct this substantial NOL over 6 years. A narrow exception is provided, if the short period is 9 months or longer and if the NOL calculated for the 12-month period is greater than the NOL for the short period.

"Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with the administration of these statutes which should not be overruled except for weighty reasons." Commissioner v. South Texas Co., 333 U.S. 496, 501 (1948); Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790, 801 (1975). Thus, it is well settled that, to the extent they are not inconsistent with the law, regulations are said to have the full force and effect of the law. See Woods Investment Co. v. Commissioner, 85 T.C. 274, 279 (1985); I.R.C. § 7805. In areas involving changes of accounting periods, the Commissioner enjoys broad discretionary power. See Houston Textile Co. v. Commissioner, 10 T.C. 735 (1948), aff'd, 173 F.2d 464 (5th Cir. 1949) (Treasury regulation governing computation of adjusted excess profits net

[2] Thus, the exception to the 6 year spreading requirement is very narrow. If the taxpayer has a NOL over $10,000 in a short period of less than 9 months, the taxpayer must spread the NOL over 6 years.

income credit allowable in a short tax year deemed valid); Forrest City Production Credit Association v. United States, 300 F. Supp. 609 (E.D. Ark. 1969), aff'd, 426 F.2d 819 (8th Cir. 1970) (Commissioner may disapprove or accept a period change made by taxpayer without prior Service approval); Stonegate of Blacksburg, Inc. v. Commissioner, T.C. Memo. 1974-213 (Commissioner may reject period changes where approval request untimely filed).

Having fallen within the terms and conditions of the approval letter, which itself is a reflection of language in the regulation designed to prevent a short period creating a substantial distortion of income (an example of which is a substantial NOL created in the short period), [redacted] must deduct its NOL over 6 years unless its NOL for the full 12-month year is greater than its NOL for the short period from [redacted] to [redacted]. To find relief within the exception to the 6 year condition, a calculation of the 12-month NOL must be made, so that it can be compared to the 9-month NOL of approximately [redacted]. This calculation is the crux of the case.

[redacted] points to the language of Treas. Reg. § 1.443(b)(2)(iii)(a) which reads, in part, that the taxable income for the 12-month period is computed under the same provisions of law as are applicable to the short period.

[redacted] argues that the fact that there is a requirement to put the short and long tax periods on the same footing indicates that the same law be applied to the short period and the 12-month year when losses are involved. However, while section 443 and the regulations require an annualization of taxable income, this requirement does not apply to a NOL.

In fact, it is well established that a "net operating loss sustained during a short taxable period occasioned by a change of accounting period may not be annualized for carryback or carryover purposes." 2 Mertens, Law of Federal Income Tax § 13.37 (1990). This flows from Treas. Reg. § 1.442-1(b)(1), which requires approval for a change in accounting period, including an agreement to remedy any substantial distortions of income, an example of what is creating a short period in which there is a substantial net loss.

Rev. Rul. 56-436, 1956-2 C.B. 297, states in full:

> In the case of a return filed for a period of less than 12 months due to a change in the accounting period of the taxpayer, section 443(b) of the Internal Revenue Code of 1954 specifically states that the "taxable income" shall be placed on an annual basis, and its counterpart, section 47(c) of the Internal Revenue Code of 1939, states that

> the "net income" shall be annualized. <u>But there is no provision in either of these sections, by implication or otherwise, that permits a "net loss" sustained during a short taxable period, occasioned by a change of accounting period, to be annualized for carryback and carryover purposes under the appropriate sections of either Code relating to net operating losses.</u> (Emphasis added).

Thus, a bifurcation exists between taxable income and NOLs in a short tax year caused by a period change. Taxable income is to be annualized under section 443 and Treas. Reg. § 1.443-1, which requires that annualization to be based on the same provisions of law. However, a NOL created by a short period is never annualized, but instead is subject to conditions and terms as authorized in Treas. Reg. § 1.442-1(b)(1) (expressed in Rev. Proc. 85-16 and found in the approval letter), which requires a 6 year spread of a substantial NOL. The applicable exception to the 6 year spread requires a comparison of the short period NOL with a 12-month period NOL. This comparison requires a separate calculation of the 12-month period NOL.

According to the terms of the approval letter, the calculation is "the net operating loss for a full 12-month period beginning with the first day of the short period." The first day of the short period was [redacted], and thus the 12-month period would end on [redacted]. If a hypothetical taxpayer had a fiscal year ending on [redacted], the NOL of such taxpayer would be subject to the section 453C's proportionate disallowance rules. Likewise, there is no significant reason that [redacted]'s calculation of a NOL for a 12-month period should not be subject to the laws as they exist at the end of the 12-month period. The NOL for the full 12-month period, ending on [redacted], would be subject to section 453C, resulting in NOL calculation of approximately $[redacted]. The 12-month period NOL would be less than the short period NOL, thus requiring that [redacted] spread the short period NOL over 6 years.

The important concept is that the calculation of the 12-month period NOL requires a comparison with the short period NOL, and that such comparision requires that <u>the law as it exists as of the final day of the 12-month period is to be applied</u>. Calculating the 12-month period NOL to compare with the short period NOL is like comparing two "snapshots". Logically, the image is developed under the laws as they exist when the snapshot is taken; as each NOL involves a separate and distinct calculation, each must therefore be treated as a separate tax period.[3] If there were rate changes affecting tax years ending after [redacted], those rates would be applied in calculating the 12-month NOL. If there were law changes favorable to a taxpayer, such as an allowance of greater deductions, such changes would be applicable in calculating the 12-month period NOL.

Being viewed as two separate calculations, involving two separate time periods, it follows that such calculations must be based on the provisions, rates, and laws that apply to the time period for which the calculation is made. Consequently, the calculation of the NOL of [redacted] for the 12-month period should be determined by the application of the law which was applied to taxpayers with tax years ending on [redacted]. The law then in effect included section 453C, which resulted in a recognition of income on installment sales based upon the proportionate disallowance rules, which recognition reduced the NOL to approximately $ [redacted] for the 12-month period. Comparing this figure with the NOL for the short tax year (approximately $ [redacted]), it is clear that the taxpayer did not meet the narrow exception provided in the approval letter and in Rev. Proc. 85-16. Thus, [redacted] is bound by the terms and conditions of the approval letter, which requires a spread over 6 years of any NOL created in the short year.

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[3] Net income from a short period, on the other hand, must be annualized under the same provisions of law. A snapshot of net income is taken, and this image is enlarged to an annual size, so that the image can be cropped properly in determining the amount of tax to be paid on the short period taxable income.

Because there is no case law on this specific issue, and there is no regulation or ruling addressing this issue, there are hazards of litigation. However, for the exception to apply to [redacted], a calculation must be made of the 12-month period, to be compared to the short period NOL. Logic dictates that this calculation be made under the law as it exists when the calculation is taken. We are confident that this logic supports our position in litigation.

If you have any questions, please call Duke Osborne at FTS 566-3521.

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